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No. 80-1745

In the Supreme Court of the United States

OCTOBER TERM, 1981

F. W. WOOLWORTH CO.,
Appellant,

v.

TAXATION AND REVENUE DEPARTMENT OF THE STATE OF NEW MEXICO,
Appellee.

On Appeal from the Supreme Court of New Mexico

BRIEF OF AMICUS CURIAE STATE OF ILLINOIS IN SUPPORT OF APPELLEE

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TAXATION AND REVENUE DEPARTMENT OF
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BRIEF OF AMICUS CURIAE STATE OF ILLINOIS IN SUPPORT OF APPELLEE

STATEMENT OF INTEREST

The decision in this case will affect the tax revenues and the burden of taxation in Illinois and every other state which imposes an income tax. Also, it will affect the development toward full and fair apportionment of income among the States. See Corrigan, *Toward Uniformity in Interstate Taxation*, Tax Notes, pp. 507-14 (September 15, 1980). Illinois is not a member of the Multistate Tax Commission, but it has adopted substantially all of the Uniform Division of Income

for Tax Purposes Act (UDITPA) apportionment provisions. Ill. Rev. Stat. (1981) Ch. 120, Article 3. As such, Illinois is concerned that this Court be informed about two essential elements of UDITPA — business income and combined apportionment — and that these two elements withstand constitutional scrutiny.

THE DEFINITION OF "BUSINESS INCOME" GUARANTEES CONFORMITY WITH THE DUE PROCESS CLAUSE

A. *MOBIL* Does Not Prevent A State From Apportioning Income Earned On Stock Investments If It Constitutes "Business Income"

Appellant wants to avoid state taxation on "foreign source" income generated by its investment in certain corporations. It contends that unless two corporations are functionally integrated, all dividend income received by the payee should be attributed to the business activities of the payor.

This ignores the well-established state and federal tax principle that a dividend is taxed as income to the payee, and it is different from profits which are taxed as income to the payor. *In re Goodyear Tire and Rubber Co.*, 133 Vt. 132, 335 A. 2d 310 (1975).

Appellant's argument is also totally at odds with this Court's decisions in cases involving intangible property or the income derived therefrom and apportioned state taxes. *Adams Express Co. v. Ohio State Auditor*, 164 U.S. 194 (1897) rehearing denied 166 U.S. 185; *Ford Motor Co. v. Beauchamp*, 308 U.S. 331 (1939); *Mobil Oil Corp. v. Com'r. of Taxes of Vermont*, 445 U.S. 425 (1980). These cases hold that intangibles or income from intangibles may be appor-

tioned among the jurisdictions in which the taxpayer conducts unitary business activities. See *Curry v. McCanless*, 307 U.S. 357, 367 (1939).

Appellant principally relies on *Mobil Oil, supra*, but it is clear that this reliance is misplaced, and, in accord with prior decisions of this Court, *Mobil* supports the tax imposed by appellee. *Mobil* decided that there is nothing about the character of income earned from investments in corporations operating abroad that precludes state taxation by the apportionment method. Simply because income is received in the form of dividends or because it is received from a "foreign source" does not mean that it can escape an apportioned state income tax. In order to avoid taxation on investment income, a taxpayer must demonstrate that there is no "minimal connection". It must show that the income " . . . was earned in the course of activities unrelated to the [conduct of activities in the taxing State.]", 100 S. Ct. at 1232; that " . . . the business activities of the dividend payor have nothing to do with activities of the recipient in the taxing State,", 100 S. Ct. at 1233-4; or that there was " . . . unrelated business activity on the part of its subsidiaries and affiliates . . . ", 100 S. Ct. at 1234. A taxpayer cannot make this showing where the income in question is "business income". *Infra*, P. 5

Appellant's argument is not framed in terms of "unrelated business activities". It is framed in terms of "functionally integrated" corporations and it confuses the factual findings in *Mobil* with the legal principles enunciated therein. This Court found that *Mobil* together with its subsidiaries and affiliates engaged in or contributed to an integrated petroleum enterprise. 100 S. Ct. at 1230. This finding provided a relationship of business activities which satisfied the Due Process Clause. (The record in this case shows that appellant also operated an integrated enterprise.) However, the integrated enterprise found to exist in *Mobil* was not referred to as the

only situation in which the constitutional standard could be met. The language quoted above makes it clear that a state can apportion dividends if they constitute "business income" as defined in UDITPA.

In addition, one should keep in mind the difference in the statutes involved. Vermont apportions federal taxable income, with minor modifications, so the unitary business principle is a useful context in which to view the Vermont statute and the income earned from Mobil's business activities.[1] UDITPA, on the other hand, determines the contours of a unitary business,[2] it distinguishes between business and nonbusiness income, and then it apportions only business income. *Mobil* did not consider whether the relationship of income to business activity, required under UDITPA's definition of business income, conforms to the requirements of the Due Process Clause. Thus, appellant's contention that *Mobil* prohibits the apportionment of dividends unless the corporations are functionally integrated is unjustified.

All of the States which impose an income tax (or a privilege or franchise tax measured by net income) have chosen to apportion income earned from business activities conducted within and without a State rather than to separately account for income earned within a State. Although appellant seems to recognize the shortcomings of separate accounting, it nonetheless argues that apportionment can only be used if

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[1] This is not to say that the Due Process Clause requires a State to find that a unitary business exists before it can apportion, without modification, all federal taxable income. The issue has not been decided by this Court. See Vt. Stat. Ann., Tit. 32, § 5811 and § 5833(a).

[2] *Caterpillar Tractor Co., et al., v. Lenckos*, 84 Ill. 2d 102, 417 N.E. 2d 1341 (1981) *sub nom. Chicago Bridge & Iron Co. v. Caterpillar Tractor Co., Illinios Department of Revenue, et al.*, prob. juris. noted __ U.S. __, Dk. No. 81-349, Nov. 9, 1981.

it is impossible to separately account for an income-producing activity. It then claims that the income in question can be separated from the income earned by its unitary business activities. However, this analysis places a double burden on the appellee and the other States; first, to adopt a method of fair apportionment and second, to prove that apportionment is necessary to tax each income-producing activity. The second burden defeats the purpose of apportionment[3] and it circumvents the real question — namely, whether the income in question is business income earned by a unitary business which operates in part in the taxing State.

B. "Business Income" Includes Income Earned On Property Which Is Acquired And Managed As An Integral Part Of A Taxpayer's Trade Or Business

Under UDITPA, the definition of business income includes income from "intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations". Ill. Rev. Stat. (1981), Ch. 120. § 15-1501(a)(1); UDITPA § 1(a). Business income is apportioned to the state according to a three-factor formula of property, payroll and sales. Ill. Rev. Stat. (1981), Ch. 120, § 3-304(a); UDITPA § 9. Appellee has enacted similar statutory provisions, and appellant has not challenged them as a matter of constitutional law. In fact, appellant acknowledges that the business income test may be

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[3] Similarly, suppose three lawyers form a partnership and agree to split equally all income and expense. After a year, if one partner claimed he should receive all of the income paid by one client because he alone represented the client, this would defeat the purpose of the partnership agreement.

appropriate in some situations, but it does not suggest any constitutional guidelines. Woolworth's Brief, P. 18-19; ASARCO's Brief, P. 18.

The Court below reviewed the factual record and found that the income in question should be classified as business income. It was earned as a result of investments in subsidiaries which were acquired and managed as integral parts of appellant's business conducted in part in the State. There is substantial evidence in the record to support this finding, and there are no "exceptional circumstances" which require a reexamination of the record on appeal. *Evco v. Jones*, 409 U.S. 91, 95 (1972); *Cal. Retail Liquor Dealers Ass'n. v. Midcal Alum.* 100 S. Ct. 937, 946-7 (1980); *Fry Roofing Co. v. Wood*, 344 U.S. 157, 160 (1952). Moreover, appellant has not challenged the application of UDITPA to the facts of its case.

The "business income" test has several characteristics. It is not the same as combined apportionment; it applies to all types of income, not just dividends; and it more than meets the due process requirement that the income be related, or minimally connected, to the business activities conducted in part in the taxing State.

Combined apportionment determines the contours or the members of a unitary business. Business income is the apportionable income earned by a trade or business. Combined apportionment is used if two or more corporations are related through common ownership and their activities are integrated with, contribute to or dependent upon each other. Business income is apportioned if the property generating the income is acquired and managed as an integral part of a corporation's trade or business. If a corporation is a member of a combined group, its business income is combined with the business income of the other members of the group, all of which is included in the combined apportionment formula. Since these are two distinct tax concepts, one should not com-

pare the results of each in an attempt to determine what is a correct or fair tax. *Infra*, p. 10. Each concept should be judged on its own merits and on the fact situation in which it is applied.

Business income, by definition, identifies the amount, and only that amount, of apportionable income a taxpayer earns in the conduct of its trade or business. It is a test of general applicability. Functional integration, on the other hand, is a test of limited applicability. It applies only to income earned on stock investments, including dividends, interest and capital gains. For instance, compare the applicability of the business income test and the functional integration test to the following situations: interest earned on working capital deposited in a bank; interest earned on loans to affiliates, see *Qualls v. Montgomery Ward Co., Inc.*, 585 S.W. 2d 18 (1979); dividends paid by an affiliated supplier like ARAMCO pays to Mobil; capital gains earned on the activity of buying and selling companies, see *Atlantic Richfield Co. v. State of Colorado*, 601 P.2d 628 (1979); income from providing management or technical services; patent and royalty income; and sales to customers. Determining what is business income in these situations will more than establish whether the income was earned in an activity related, or minimally connected, to the taxpayer's business. Deciding whether the payor and payee are functionally integrated is not determinative of whether a state may constitutionally tax these types of income. If functional integration is adopted as the exclusive test for determining apportionable income earned on stock investments, a different due process test will have to be used for the types of income outlined above. But *Mobil* expressly decided that there was nothing about the nature of dividend income which distinguished it, in a due process sense, from the other income which a state may tax.

One requirement of the Due Process Clause identified in *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978), is that there be a "minimal connection" between the interstate activities and the taxing State. *Mobil* stated that income earned by activities unrelated to the taxpayer's business may escape an apportioned tax. Income earned from property which was acquired and managed as an integral part of a taxpayer's business certainly falls within this constitutional framework.

THE FACTORS IN THE APPORTIONMENT FORMULA DO NOT NEED TO BE ADJUSTED

A. Appellant Has Not Shown By Clear And Convincing Evidence That Extraterritorial Values Are Being Taxed

Appellant contends that under *Mobil* if appellee apportions dividends, it must include some percentage of the property, payroll and sales of the payor in the payee's apportionment formula.[4] It argues that if this adjustment is not made, the formula will be "inherently arbitrary" and it will necessarily overstate the income properly attributable to the State. Appellant claims to have met its burden of proving that extraterritorial values are being taxed by claiming that the appellee's method results in a higher tax liability and by using a hypothetical example to show that receiving dividends from a sub-

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[4] This assumes that the dividends represent income earned by the payor and that the apportionment formula must reflect the factors which generate the income. This proposed adjustment is a hybrid of combined apportionment. It is impossible to reconcile this position with appellant's statement that it agrees with the position against combination taken by the appellant in *Chicago Bridge & Iron Co., supra*. See ASARCO Brief, p. 31; Woolworth Brief, p. 37. In effect, appellant is asking this Court to authorize an adjustment which it thinks is unconstitutional.

sidiary will result in a higher tax than receiving income from a division.

At the outset, one should remember that the income being taxed was earned from the activity of acquiring and managing intangible property which is integral to the taxpayer's business conducted in part in the taxing State. The three factor formula already reflects the property, payroll, sales and expense attributable to this activity. The sales factor includes the dividends received. The payroll factor includes the salaries of the employees and officers who make and manage the investments. The property factor includes the office space and equipment necessary for conducting this activity. Appellant's business income has been reduced by the expenses of acquiring, managing and disposing of its investments, e.g. salaries, office supplies and equipment, travel, communication, and interest on indebtedness that otherwise would not have been incurred but for the stock investment. If the income in question really is nonbusiness income, all of these items should be excluded from the apportionment formula. Appellant has not offered to do this, undoubtedly because it would be impossible to separate these items from its other business activities.

A taxpayer who attacks an apportionment formula must show by clear and cogent evidence that it results in taxing extraterritorial values. *Butler Bros. v. McColgan*, 315 U.S. 501 (1942). Appellant claims to have met this burden by noting that the formula will cause the percentage of its tax liability (not amount) to increase significantly and by using a hypothetical example to show that receiving dividends from a subsidiary will result in a higher tax than receiving income from a division. These two pieces of evidence are neither clear nor convincing. The fact that there is a difference between what the parties think the tax should be does not prove or disprove which party is correct. The hypothetical example

used by appellant is faulty, as will be shown, for several reasons: the taxation of dividends and the use of combined apportionment are not comparable; the amount of dividends paid each year are not related to the property, payroll and sales of the payor; and other examples can be used to show the tax avoidance and illogical consequences caused by the proposed adjustments.

First, as was mentioned earlier, the taxation of dividends and the use of combined apportionment are separate and distinct tax concepts. The former depends upon the relationship between the purpose of the investment and the business activity of the taxpayer; the latter depends upon common ownership and the extent of integration, contribution and dependency among the corporations. The former apportions dividends received by the payee; the latter apportions the income of the payor and the other members of the combined group. Contrary to appellant's interpretation, *Mobil* did not equate the two concepts. *Mobil* did say that the propriety of apportionment depends upon the underlying economic reality among corporations rather than divisional or corporate lines. This was in the context of finding that Mobil's investment activities were not separate from its other business activities. It was not in the context of requiring states to adjust their apportionment formulas in order to reach results similar to combined apportionment. In fact, *Mobil* expressly did not decide whether the apportionment formula should be adjusted or whether combined apportionment is required.[5] Also, *Mobil* allowed dividends from affiliates to be apportioned and affiliates are not usually considered to be part of the

[5] It is noteworthy that the use of combined apportionment is authorized in appellee's State. If the relationship between the parent and subsidiary had warranted it, appellant could have obtained the adjustment it now requests by using the combined report.

combined group. This means that, as a matter of law, appellant is not entitled to an adjustment in the formula whenever investment income is apportioned.

Second, the hypothetical example and the proposed adjustment are misconceived because they presume that the dividends, like net income, are related to the property, payroll and sales of the payor. They are not because the amount of dividends paid by a corporation is usually less, but may be more, than current net income. The net income available for dividends is first reduced by federal, state and foreign taxes and reserves for expansion. Also, accumulated earnings and profits limit the amount of taxable dividends which may be distributed. See I.R.C. § 312; BNA Tax Management Portfolios, *Earnings and Profits,* 175-2nd. In theory, if the income of the payor includes dividends received from its subsidiaries, then the earnings and profits of these second-tier corporations would also affect any factor adjustment. Appellant's reason for adjusting the apportionment formula is that the factors should reflect the "source" of the dividend income. While property, payroll and sales reasonably reflect the income-producing activities of the payor, they do not reasonably reflect the dividends paid since they are not related to the net income and the earnings and profits otherwise available for distribution. Thus, appellant has not proposed a conceptually sound adjustment.[6]

Different hypothetical examples can be used to show that appellant's proposed adjustment can be used to avoid taxes and that it causes illogical consequences. The Idaho State Tax Commission's brief demonstrates how the proposed ad-

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[6] Appellant has not suggested how the formula should be adjusted for interest and capital gains. This reflects a severe deficiency in the rationale for why an adjustment is needed in the first place.

justment can exempt dividends or even reduce otherwise taxable income, depending on the size of the payor's three factors relative to the payee's three factors. That brief also illustrates how the proposed adjustments could attribute part of a taxpayer's income to jurisdictions in which it conducts no business activities and in which it could not be taxed. The Brief of *Amicus Curiae* Multistate Tax Commission provides examples which show that there is no equivalence in tax between the use of a combined report and the inclusion of the payor's factors in the payee's denominators.

B. A State Tax On Domestically-Earned Income Derived From Domestically-Owned Property Which Is Related To Both Domestic And Foreign Business Activities Does Not Invoke The Foreign Commerce Clause

Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434, 99 S. Ct. 1813 (1979), involved cargo containers that were "owned, based and registered abroad and that [were] used exclusively in international commerce," 99 S. Ct. at 1819. In an effort to address this narrow question, this Court declined to revive the "home port doctrine," and it did not reach the questions as to the taxability of foreign-owned instrumentalities engaged in interstate commerce or of domestically-owned instrumentalities engaged in foreign commerce. *ibid*

The instant case involves income earned and property owned by a domestic corporation which conducts both interstate and foreign activities. The property is intangible, and it is an integral part of appellant's business. Since appellant conducts business in other jurisdictions as well as the taxing State, the intangible property does not have a fixed situs, nor is the income treated as having a single source.

Japan Line involved foreign-owned tangible property which was used exclusively in international commerce. This case involves domestically-earned income derived from domestically-owned intangible property which is an integral part of a business with both interstate and foreign activities. Appellant has not demonstrated that the State tax is imposed on foreign commerce, and this is a prerequisite to any argument premised on the two precepts enunciated in *Japan Line*.

Japan Line found that a local tax was prohibited where actual multiple taxation was established and where a treaty between the United States and Japan expressly prohibited the tax in question. This Court should find that the tax is permitted, not only because it is not imposed on foreign commerce, but because there is no evidence of multiple taxation in fact and there is no federal statute or treaty which prohibits the state tax. In addition, appellant has not shown that the tax is discriminatory. The State tax reaches all dividends included in both federal taxable income and business income regardless of whether they are paid by domestic or foreign corporations. The fact that part or all of some dividends are deducted in computing federal taxable income whereas other dividends are adjusted by way of a federal tax credit is a matter of federal law and elections made by a taxpayer. See I.R.C. §§ 78, 243-246, 901-908, 951-964. The State statute does not subject foreign commerce to a different burden of taxation than domestic commerce. Also appellant has not shown that the State tax is "inimical to the national commerce" such that this Court should act where Congress has not acted. In fact, if this Court adopted appellant's argument, it would infer a constitutional preference for allocation of dividend income to a foreign situs rather than apportionment among the States. This is what the Court refused to do in *Mobil*.

CONCLUSION

For the foregoing reasons, *Amicus Curiae* State of Illinois respectfully request this Court to affirm the decision of the Court below.

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